V. TRAFFIC RATED BY A CLEC AS LOCAL SHOULD BE TREATED BY THE ILEC AS LOCAL FOR PURPOSES OF TRANSPORT AND TERMINATION

In the Order, the Commission gave the States the authority to determine what geographic areas should be considered local for the purpose of applying either reciprocal compensation obligations or access charges. NCTA is concerned that the vast majority of States will define a CLEC's local calling area by reference to the ILEC's service territory even if portions of their local service areas are not the same. This would have a profound impact on the advent of facilities-based competition, particularly residential service competition, since it could force CLECs to pay exchange access rates for the transport and termination of their local traffic. On reconsideration, the Commission should rule that traffic rated by the CLEC as local is entitled to local transport and termination rates.[77]

As NCTA and Continental Cablevision explained in this proceeding, CLECs are likely to have different local service areas than ILECs because of historical and technological differences in the development of their respective networks.[78] These differences promote competition by allowing CLECs to distinguish themselves in the marketplace through the establishment of wider local calling scopes. If a State permits an ILEC to impose access charges on calls rated by a CLEC as local but which the ILEC treats as toll, it will in effect impose the

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[77] At the very least, the Commission should establish a presumption that the CLEC's local calling area will determine the point of demarcation between access and transport and termination. An ILEC could rebut such a presumption only upon a clear and convincing showing that deferring to the CLEC's local calling area boundaries would be inconsistent with the development of local competition.

[78] Order, ¶ 1035 n.2477 (citing letter from Brenda L. Fox, Vice President, Federal Relations, Continental Cablevision, to Robert Pepper, Chief, Office of Plans and Policy, FCC, July 22, 1996); Reply Comments of the National Cable Television Association (May 30, 1996) at 17-18.

ILEC geographic calling areas and rate plans on CLECs and thereby undermine competition by preventing competitors from exploiting their service areas.

Even within some areas that ILECs themselves deem "local," ILECs have attempted to impose access charges on CLECs. In order to foster local competition, the Commission should also prohibit this practice. Many ILECs today offer expanded local calling area plans under relevant State tariffs that typically enable residential customers to pay an additional flat rate charge for calls within an area contiguous to the area initially deemed to be local. These "expanded local" areas, however, can encompass areas that the ILEC does not deem "local" for purposes of terminating access compensation arrangements with CLECs.[79] These practices inappropriately and unfairly impact the ability of CLECs to compete, particularly in the residential market that the ILECs target with such plans. The Commission should clarify that local transport and termination charges apply within any area in which ILECs offer local, expanded local, extended area service, or optional expanded local calling plans.

Efforts by a CLEC to develop an expanded local calling scope may also be thwarted where the CLEC uses an NXX code in a broader geographic area than the ILEC associates with that code. For example, a CLEC's calling area might encompass both Kansas City and Topeka while the ILEC's is limited to Kansas City and its immediate environs. If the CLEC uses a Kansas City NXX for all its customers and its switch is located in Kansas City, the ILEC might try to impose a toll surcharge on a call placed by one of its customers in Topeka to one of the

[79] Unlike Extended Area Service ("EAS") plans, which are themselves deemed local for all purposes (and are therefore not optional expanded local calling plans), these plans are optional and can therefore result in the situation whereby two neighboring ILEC customers in the same community can have different "local" areas.

CLEC's customers also located in Topeka even though the call originates and terminates in Topeka. This surcharge would discourage the ILEC's customer from calling down the street to a CLEC customer and would competitively disadvantage a CLEC attempting to attract subscribers. To prevent this impediment to competition, the Commission must preclude the imposition of such a surcharge.[80/]

CONCLUSION

For the foregoing reasons, the Commission should reconsider and revise its Order in accordance with the arguments set forth herein.

Respectfully submitted,

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80/ Here again, the competitive threat posed by this scenario would be effectively implemented via swift imposition of full number portability. See supra at Section I.

APPENDIX A

BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION

WASHINGTON, D.C.

In the Matter of Implementation of
the Local Competition Provisions of
the Telecommunications Act of 1996 } CC Docket No. 96-98

Declaration of Bruce M. Owen

I. Introduction

I am an economist and president of Economists Incorporated, an economic consulting firm located at 1200 New Hampshire Ave., N.W., Washington, D.C. 20036. I discuss my qualifications in a declaration that I previously filed in this proceeding.

This declaration proposes that the Commission revise the standards it set forth for determining avoided costs when calculating reseller discounts. (¶¶ 911-920) I first comment on the role of policy considerations in determining avoided cost. Regulators have substantial leeway to choose between different methods of calculating avoided costs that are consistent with the statute. In using this authority, regulators can and should be aware of policy considerations. I then suggests revisions to the Commission's standards for measuring avoided costs.

II. Policy considerations and the standards for calculating avoided costs.

Regulators can and should be mindful of policy considerations in determining standards for calculating avoided costs. The Commission comments that "An avoided cost study may not calculate avoided costs based on non-cost factors or policy arguments," (¶914) and certainly, once a set of standards for measuring avoided costs is in place, policy considerations will have no role in that measurement. Policy considerations, however, may play a substantial role in determining those standards.

In setting standards for avoided costs, regulators often must choose between different methods, each of which would be consistent with the statute. In large part, these choices stem from the underlying weaknesses in the Uniform System of Accounts (USOA), on which most measures of avoided costs are based. The USOA is a "historical financial accounting system,"[1] not a cost accounting system. Its categories bear little relationship to such economic concepts as fixed and variable costs. Moreover, the measurement of costs using this system is related primarily to accounting concepts, economic concepts play little role. For example, depreciation is measured using accounting rules and thus is unlikely to be closely related to true economic depreciation. As a result, the measurement of capital costs, and by implication fixed costs, is likely to be seriously inaccurate. Furthermore, accounts in the USOA were not developed to separate retail from other costs. Thus, the USOA is far from allowing an unambiguous determination of avoided costs.

Several examples in which regulators had to choose between different permissible options may be seen in the "First Report and Order." Because the USOA was not designed to separately measure retail costs, regulators must choose what accounts should be considered presumptively avoidable or unavoidable. Moreover, as the Commission recognizes, some share of the costs in categories rebuttably presumed avoidable in fact cannot be avoided. Regulators will have to set a value for this share based on evidence that the Commission itself admits is currently insufficient. (¶ 928) Regulators also must decide what, if any, share of indirect costs is to be classified as avoidable. Furthermore, regulators must decide whether or not to use a reseller discount that is uniform across services. (The Commission leaves this decision to state regulators; see ¶ 916.)

In choosing among different options, regulators should be mindful that mistakes in one direction are more costly than mistakes in another. In particular, mistakes that inflate the reseller discount will discourage facilities-based competition while mistakes that make the discount too low will discourage reseller

1 47 CFR Ch. 1 (10-1-95 edition) § 32.1.

competition. As facilities-based competition is more valuable, too low a discount is preferable to too high a discount. Thus, regulators should use their authority in ways that tend to reduce the discount.

III. The Commission has overstated the extent of avoided direct costs.

The Commission has designated costs in six categories as subject to a rebuttable presumption of avoidability. These categories are 6611, Product Management; 6612, Sales; 6613, Product Advertising; 6621, Call Completion Services; 6622, Number Services; and 6623, Customer Services. The Commission notes that some of these expenditures may be incurred by a firm selling at wholesale, but it suggests that this share is very small. In ¶ 928, the Commission suggests that the share of these costs that is avoidable will be limited to 10% of product management, product advertising, and customer services and none of call completion and number services.

This procedure is likely to overstate avoided direct costs. In particular, substantially more than 10% of product management and product advertising costs (6611 and 6613) are likely to be unavoidable. LECs that sell at wholesale will face a different set of competitors and customers and have different incentives than resellers. Thus, they are unlikely to be able to shift a significant share of these expenditures to the resellers.

Product management expenses are described as follows:

> This account shall include costs incurred in performing administrative activities related to marketing products and services. This includes competitive analysis, product and service identification, and specification, test market planning, demand forecasting, product life cycle analysis, pricing analysis, and identification and establishment of distribution channels. (47 CFR Ch. 1 (10-1-95 Edition) § 32.6611)

Selling through wholesalers is unlikely to enable a LEC to avoid a significant fraction of these expenses. Even if a company does not sell at retail, it still must be concerned with the markets for its products and the factors that affect their products' future acceptance. For example, a LEC is likely still to have to analyze its competitive position relative to other LECs and to forecast demand for its services.

Wholesalers have no reason to do competitive analyses for the LECs, and while they may want to forecast the demand for their services, that will not be the same as the demand faced by the LEC. (Moreover, such studies are usually highly proprietary, and wholesalers are unlikely to share them with the LECs.) Thus, the need for LECs to do competitive analysis and demand forecasting will not change significantly. The LEC may avoid some costs of establishing distribution channels, but even if it never sells at retail, it still must establish and maintain its relationship with wholesalers, who will be its direct customers.

Advertising expenses are described as follows:

> This account shall include costs incurred in developing and implementing promotional strategies to stimulate the purchase of products and services. This excludes nonproduct-related advertising . . . (47 CFR Ch. 1 (10-1-95 Edition) § 32.6613)

Even if a firm does not sell at retail, it still will find it rational to promote the sales of its products. For example, a LEC may wish to advertise its products to consumers to develop a brand name, even if it sells those products through wholesalers. A wholesaler who does not have an exclusive right to resell the LEC's products will have no incentive to develop that brand.

The major determinant of a firm's advertising expenditures is its competitive environment, not whether or not it sells directly to consumers. A firm in a competitive industry that must vie for sales with many competitors is likely to spend much more on advertising than a regulated monopolist. This fact is shown by the experience of AT&T. As shown in Table 1, after divestiture, when AT&T suddenly faced a much more competitive environment, its advertising expenditures increased dramatically, even though it was a much smaller firm overall.

Table 1: Advertising Expenditures and Sales of AT&T, Adjusted for Inflation, Before and After Divestiture[2]

Year	Advertising Expenditures	Sales
	(thousand dollars)	
Before		
1979	303,264	62,663,148
1980	314,892	61,799,760
1981	326,106	64,870,938
1982	386,660	68,058,495
After		
1984	547,770	31,892,707
1985	483,488	31,938,976
1986	477,089	31,121,431
1987	467,296	29,566,240

A LEC selling through resellers will be analogous to a consumer goods manufacturer selling through unaffiliated retailers. Manufacturers of consumer goods often spend considerable sums on advertising, even though they do not sell directly to consumers. This point is illustrated in Table 2, which shows advertising expenditures as a share of sales for a number of consumer goods manufacturers and for consumer goods manufacturing industries. Consumer goods manufacturers' expenditures on advertising are much larger, relative to their sales, than those currently incurred by regulated LECs, as shown in Table 3. Thus, it seems likely that little if any of ILECs' product advertising costs are avoidable.

In summary, an ILEC that sells through wholesalers is likely still to incur the majority of product management costs and all or almost all product advertising costs as when it sold only at retail. Therefore, the Commission should not attach any presumption of avoidability to the costs in these categories.

2 Data are from Advertising Age, various issues. They are adjusted for inflation using the Consumer Price Index, with the base period 1982-4.

Table 2: Advertising Expenditures as a Share of Sales for Major Consumer Goods Manufacturers and Consumer Goods Manufacturing Industries[3]

Major Consumer Goods Manufacturers	
Warner-Lambert Co.	28.1%
Kellogg Co.	19.1%
Coca-Cola Co.	9.6%
General Mills	10.1%
American Home Products Corp.	9.7%
Grand Metropolitan	10.8%
Johnson & Johnson	12.0%
Unilever NV	7.3%
Nestle SA	9.7%
Consumer Goods Industries	
Food & Kindred Products	4.3%
Tobacco Manufacturers	8.6%
Apparel & Other Textile Products	1.7%
Furniture & Fixtures	1.5%
Printing & Publishing	2.1%
Motor Vehicles & Equipment	1.2%

Table 3: Advertising Expenditures as a Share Of Revenues for the Regulated Activities of Local Exchange Carriers, 1995[4]

Bell South	0.7%
Bell Atlantic	0.4%
Ameritech	1.1%
US West	0.6%
Nynex	0.8%
PacTel	0.8%
SW Bell	0.7%
All RBOCs	0.7%
GTE	0.9%

3 The individual manufacturers on this list are the 10 largest consumer goods manufacturers, ranked by U.S. sales, from the top 25 U.S. Advertisers according to *Advertising Age,* September 27, 1995. Data pertain to U.S. advertising expenditures and sales, except for Unilever, where North American sales were used because U.S. sales were unavailable. These data are for 1994 and are from *Advertising Age.* Data on consumer goods industries are from Internal Revenue Service, "Statistics of Income 1992, Corporation Income Tax Returns." Sales for these industries are assumed equivalent to business receipts. These data are for 1992.

4 Data are from ARMIS reports. Advertising is measured by account 6613 and revenues by account 530.

IV. The Commission's methodology is likely to overstate indirect avoided costs.

The Commission has chosen to identify certain indirect expenses as avoidable. In doing so, they have encountered a serious problem. Indirect expenses by definition cannot be directly related to any specific function of a LEC. Therefore, one cannot determine which of these expenses are related to the retailing function. The Commission has responded to this problem by stating that indirect expenses "are presumed to be avoided in proportion to the avoided direct expenses identified in the previous paragraph." (¶ 918)[5]

The Commission has dealt with the issue of the allocation of costs that cannot be directly assigned to specific activities before, in addressing the separation of carriers' regulated and non-regulated costs. (47 CFR § 64.901) In Part 64, the Commission describes costs that cannot be directly assigned to regulated or non regulated activities as common costs. (In this case, indirect costs are analogous to common costs because they cannot be directly assigned to retail or non-retail activities.) The Commission then gives a hierarchy of methods to be used to allocate common costs. The method that is the third and last choice in this hierarchy is the one that the Commission has adopted as its first choice in this proceeding, the use of a general allocator based on directly assigned expenses.

Moreover, the Commission's proposed rule is arbitrary and inconsistent with the nature of indirect costs. By allocating indirect costs in proportion to direct avoided costs, the Commission in effect has adopted a fully distributed cost (FDC) method. Such an approach, as the Commission itself has recognized in the past, is economically inefficient.

> A fundamental problem with using the FDC standard to review OCPs [Optional Calling Plans] is that it relies on historical or embedded costs. Current and anticipated costs and revenues, however, rather than "sunk" historical costs, are generally the relevant factors

5 The meaning of ¶918 is unclear, and the final rules merely state (in §51.609 CFR) that "a portion of the [indirect] costs" should be included in avoided costs. (p. B-38). The Commission calculates discounts by assuming that the share of avoided indirect costs in total indirect costs is the same as the share of avoided direct costs in total expenses. (¶929-30)

> influencing business decisions to enter markets and price products. See MCI v. AT&T, 708 F.2d at 1116-7. . . . The FDC standard results in "a quite arbitrary allocation of costs among different classes of service." Id at 1116. Further, "FDC cannot purport to identify those costs which are caused by a product or service, and this is fundamental to economic cost determination." Id. It acts as a price "umbrella" which protects less efficient competitors from full price competition and, thus, can misallocate resources and result in higher prices and lower output for consumers. Id. at 1117. ["In the Matter of Guidelines for Dominant Carriers' MTS Rates and Rate Structure Plans," released October 17, 1985, 1985 FCC LEXIS 2429 *13-14; 59 Rad. Reg 2d (P&F) 70

Further, it is logically contradicted by the Commission's definition of common costs in this very Order. According to the Commission, common costs are those that are avoided only when all the services in question are shut down. Order at ¶676. But as indirect costs necessarily include common costs (the Uniform System of Accounts has no separate category for "common" costs), the Commission has determined to treat as *avoidable* costs that by its own definition would *not* be avoided if the LECs sold some services through resellers.

V. Conclusion

Regulators may make a number of important choices when setting standards for determining avoided costs; the Telecommunications Act does not dictate a single approach. In making these choices, they should be mindful of the greater value to consumers of facilities-based, as opposed to reseller, competition. The Commission's recent report and order seem to err in important ways on the side of an excessively high measure of avoided costs. In particular, these standards overestimate direct avoided costs and use an incorrect method of measuring indirect avoided costs.

I declare under penalty of perjury that the foregoing is true and correct.

Bruce M. Owen

September 30, 1996

CERTIFICATE OF SERVICE

I, Christopher J. Harvie, do hereby certify that a copy of the foregoing Petition for Reconsideration of The National Cable Television Association was sent to the following by either first class mail, postage pre-paid, or by hand delivery, this 30th day of September, 1996.

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